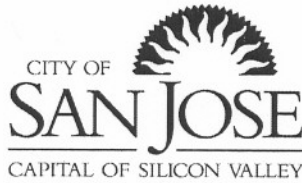


SUPPLEMENTAL

COUNCIL AGENDA: 06-27-06

ITEM: 4.4



Memorandum

TO: HONORABLE MAYOR
AND CITY COUNCIL

FROM: Paul Krutko

SUBJECT: SEE BELOW

DATE: June 22, 2006

Approved

Date

6/23/06

COUNCIL DISTRICT: #3
SNI AREA: NA

SUBJECT: City Hall Retail Project – Supplemental Information

REASON FOR SUPPLEMENTAL

Supplemental information on the financial aspects of the City Hall Retail project, the value of the services of a Master Tenant, and additional update related to labor peace.

BACKGROUND

This supplemental memorandum is intended to provide additional information related to the financial aspects of the City Hall retail project and underscore the value of the services of a Master Tenant for the City Hall retail space.

ANALYSIS

In April of 2005, the City of San Jose released a Request for Proposal (RFP) for the City Hall Retail space. The RFP was widely distributed to over 300 restaurants, retail brokers, retail developers, and operators of retail food courts such as Host International. The RFP clearly indicated that the City Hall Retail space was in a “cold shell” condition and would require substantial private investment.

After extensive outreach efforts, one proposal from a developer, Imwalle Properties was submitted for the space. Two individual tenants, Starbucks and Subway, submitted proposals. Neither

individual tenant proposal included funds for build-out of the full retail space. During the period of lease negotiations no retail tenants have inquired about the availability of the space.

Staff requested, Tim Kelly of Keyser Marston and Associates to review the terms of the lease and indicated that the City investment and overall deal structure is reasonable. A letter from Mr. Kelly is attached to this supplemental memo. Staff also reviewed the proposal with Jon Stansbury of Terranomics. Mr. Stansbury is an experienced retail broker and has done several deals in the downtown. Mr. Stansbury indicated that the construction costs and proposed rents as described by Mr. Imwalle are within market expectations, particularly given the unique City Hall location and level of tenant improvements.

The structure as proposed offers several positive elements to the City:

- In the 11th year of the lease the City receives 50% of net lease revenue paid by the tenants. This represents a significant opportunity for revenue generation.
- The Master Tenant will expend a minimum of \$854,000 of private funds to invest in the City Hall retail space.
- The City Hall retail space will generate sales tax in addition to lease revenues.
- The Master Developer, Don Imwalle, is respected as a premier retail developer throughout the South Bay. Mr. Imwalle has developed over 75 retail developments, over half of the projects are located within San Jose.
- Mr. Imwalle has excellent relationships with retail tenants and brokers. The responsibility for leasing the City Hall retail space will rest with Mr. Imwalle. City staff time and resources will not be required to release the City Hall retail space.
- In the first 10 years of the lease the City will not have to share in the costs of retail brokers enlisted to re-tenant space, if re-tenanting is required.
- Given the high cost of providing tenant improvements in the City Hall Retail space there is a very limited pool of potential developers and restaurants that can independently afford to participate in the project.

Additional Labor Peace Update

The national sub-tenant considering occupancy in the City Hall retail space has requested additional information about the Labor Peace requirements and is evaluating the impact on overall operations. As noted in the prior memorandum, any failure by sub-tenants to achieve Labor Peace would not constitute a default by the Master Tenant under the Master lease. In addition, the Master Tenant indicates that a failure by sub-tenants to achieve Labor Peace would not be a default under the sub-tenant lease.

PUBLIC OUTREACH

The New City Hall Retail Request for Proposals (RFP) was released in April of 2005 and was advertised broadly to area businesses, brokers, and developers.

A handwritten signature in dark ink, appearing to read "Paul Krutko", with a long horizontal flourish extending to the right.

PAUL KRUTKO
Director, Office of Economic Development

For questions please contact Paul Krutko, Director , Office of Economic Development at (408) 535-8181



KEYSER MARSTON ASSOCIATES

ADVISORS IN PUBLIC/PRIVATE REAL ESTATE DEVELOPMENT

MEMORANDUM

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To: Nanci Klein
San Jose Office of Economic Development

From: Tim Kelly

Date: June 22, 2006

Subject: City Hall Retail Space

Pursuant to your request, you have asked that we provide our comments on the business terms for the City Hall retail space.

The city hall retail space is approximately 6,000 sq.ft. and is currently unimproved. The space will be leased to a master lessee. The master lessee will in turn sublet the space to approximately three tenants.

The existing space is a raw shell. The desired tenants are all food establishments. To attract such tenants, all utilities, ceiling, flooring, restrooms, venting, HVAC, demising walls, connections to the grease interceptor, and related improvements to create a leasable space must be funded and construction work supervised. In addition, prospective tenants need to be targeted, tenant subleases need to be drafted, tenant improvement allowance to finish the space and other tenant related leasing costs need to be funded. Beyond costs, there is a significant management effort that needs to be undertaken.

In summary, the master lessee is being required to:

1. Invest a substantial sum in improvements necessary to create leasable space.
2. Manage the construction and accept the construction cost risk, which has some unique conditions given the location within a public building.

To: Nanci Klein
Subject: City Hall Retail Space

June 22, 2006
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3. Lease of the space to food establishments.
4. Meet all City labor requirements.

In marketing the City Hall retail space, a request for proposals was prepared and circulated by staff. Additionally staff contacted several qualified developers with direct retail experience. The selection of the proposed master lessee (Imwalle) was the result of this competitive process. In fact, there was only one bidder who could meet the desired obligations required by the City for this space.

At this point, the estimated private investment by the master lessee is \$854,000, or about \$142 per.sq.ft. of leasable area. It has been our experience in spaces such as this, there is more risk than a typical freestanding retail building that costs could exceed budget. This is a financial risk assumed by the master lessee. Also there is significant management time given that the space is a raw shell in an existing public building.

The rental rates that tenants are willing to pay for this location has not matured. Tenants are asking and receiving more favorable lease terms (rent and tenant improvement allowances) than at other more established retail locations in the downtown. Food tenants (approximately 1,500 to 2,000 sq.ft. in size) that might be willing to pay a monthly rent of \$3.00+ per sq.ft. at a more established downtown location might seek a rent between \$2.50 and \$3.00 at this particular location.

In conclusion, the master lessee is accepting financial risks related to cost of finishing the raw shell and tenant improvements allowances needed to attract tenants. Also, at least for the near term, there is a limit on tenant willingness to pay rent. The selected master lessee has put forth a business proposal that reflects these business risks and has resulted in a \$6,000 per year lease payment to the City for the first five years and a \$12,000 per year lease payment for the next 5 years. Starting in Year 11, the lease payment to the City increases to 50% of the rent received from the subtenants. The low rent in the initial years is intended for the master lessee to recapture its projected investment (\$854,000) and to provide an allowance for the unforeseen cost risks. The City rent commencing in Year 11 of 50% of the subtenants rent is viewed by the Master Lessee as a sharing of the upside through a 50/50 partnership.